(12)

No. 98-2043

In The

Supreme Court of the United States

HUNT-WESSON, INC.,

Petitioner,

v.

FRANCHISE TAX BOARD,

Respondent.

On Petition For A Writ Of Certiorari To The Court Of Appeal Of California For The First Appellate District

REPLY BRIEF FOR PETITIONER

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RULE 29.6 STATEMENT

Hunt-Wesson, Inc. is a wholly owned subsidiary of ConAgra, Inc. Its non-wholly-owned subsidiaries are ConAgra Brands, Inc. and ConAgra Limited.

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REPLY BRIEF FOR PETITIONER

Respondent makes essentially three points in its Brief in Opposition. First, the case lacks national significance because the California Court of Appeal chose not to publish its opinion. Br. Opp. 8-10. Second, the interest-offset provision can be defended as a method of "rationally correlating interest expense to business income." *Id.* at 11. Third, the interest-offset provision does not discriminate against interstate commerce because it does not apply in all cases (*id.* at 18), domiciliary and non-domiciliary taxpayers are not similarly situated (*id.* at 18-19), the overall tax is fairly apportioned (*id.* at 19-22), and the provision was not intentionally discriminatory. *Id.* at 22 n.12.

None of these points has substance. First, respondent itself has recognized the "great significance" of this case (Pet. App. at 40a), and its eleventh-hour conversion is disingenuous, to say the least. Second, respondent's attempt to cast the interest-offset provision as a method of "rationally correlating interest expense to business income" (Br. Opp. 11) ignores the plain language of the statute and the stipulated fact that the interest-offset applies only to "*business* interest expense" after the deduction of "*nonbusiness* interest expense." Stip. ¶ 11, CT p. 58 (emphasis supplied). Third, respondent's shotgun defense to petitioner's claim of discrimination disregards this Court's controlling Commerce Clause doctrine and fails to respond to the incontrovertible fact that the *effect* of the interest-offset provision favors in-state over out-of-state corporations.

In short, as we demonstrate below, an analysis of respondent's Brief in Opposition simply reinforces the case for certiorari.

I. THIS CASE HAS PROFOUND NATIONAL SIGNIFICANCE

Respondent's contention that this case lacks national significance (Br. Opp. 8-10) cannot be taken seriously. Respondent itself has explicitly recognized that "[t]he

question answered in the *Hunt-Wesson* case . . . is of great significance to taxpayers and the state." Pet. App. at 40a. It has acknowledged that this case potentially affects "[o]ver 40,000 corporations . . . which report their activities both within and without California" (*id.*) and which "pay over 70% of the bank and corporation tax collected by California." *Id.* And it has observed that "[e]ach of these corporations has the potential to have income which is apportioned by formula and income which is not apportioned by formula so that the amount of interest expense and the manner in which it will be taken into account is governed by Section 24344(b)." *Id.*

Furthermore, there is no merit to respondent's assertion that this case is not certworthy because the Court of Appeal rejected respondent's request that the court's opinion be published. If it were otherwise, then the state court's judgment whether to certify an opinion for publication rather than this Court's criteria governing review on certiorari (*see* United States Supreme Court Rule 10) would determine whether a petition were granted. Moreover, equating the publication of an opinion with its certworthiness would render the issue raised by this case as "capable of repetition yet evading review," *Dunn v. Blumstein*, 405 U.S. 330, 333 n.2 (1972), as courts continue to affirm respondent's position without certifying their opinions for publication. *See, e.g., F.W. Woolworth Co. v. Franchise Tax Bd.*, No. A075506, California Court of Appeal, First Appellate Dist., Div. 3 (Dec. 11, 1998) (not certified for publication), *petition for cert. filed*, June 7, 1999 (No. 98-1967).

Finally, respondent's attempt to minimize the national significance of this case is belied by the amicus briefs filed by the Tax Executives Institute (TEI) and the Committee on State Taxation (COST) urging the Court to grant Hunt-Wesson's petition. TEI has approximately 5,000 members representing nearly 2,800 of the leading businesses in the United States and Canada. COST has a membership of over 500 multistate corporations engaged in interstate and international commerce. The intense

interest that TEI and COST have expressed in this case, and their deep concern over its widespread implications, demonstrates the national importance of this controversy.

II. CALIFORNIA'S INTEREST-OFFSET PROVISION DOES NOT ALLOCATE INTEREST EXPENSE TO RELATED INCOME

According to respondent, this case is simply about a statute that allocates interest expense to related income, *i.e.*, to the income produced by the loans on which the interest was paid. Respondent repeats this theory throughout its brief, using different formulations. Respondent thus characterizes the interest-offset provision as a "rule for correlating or matching, a corporation's interest expense with the category of income . . . to which it relates," (Br. Opp i); as a rule "rationally correlating interest expense to business income," (*id.* at 11); as a "method to correlate, or match, a corporation's interest costs to the type of income to which it relates," (*id.* at 12); as a rule attempting "only to fairly correlate that portion of interest expense which is attributable to . . . tax-exempt income," (*id.* at 14); as a rule "premised on the notion that interest expense is offset because it is economically related to the receipt of nonbusiness dividend and interest income," (*id.* at 14 n.7); as a rule designed to address "the economic relationship between interest costs and dividend income," (*id.* at 14-15); and as a rule which "correlate[s] expenses between taxable income and nontaxable income." *Id.* at 16.

If respondent's characterization of the interest-offset provision were accurate, petitioner would not be here. Petitioner takes no issue with the widely accepted principle that interest expense should be allocated to the income that it helps produce.[1] But respondent's

[1] Indeed, petitioner acknowledges that interest expense may be allocated to the income it produces by any of a variety of

characterization of the interest-offset rule as a method for "correlating" or "matching" interest expense to related income is demonstrably false. Once the false predicate underlying respondent's argument is removed, its entire argument collapses.

First, the statute itself unequivocally requires that every dollar of net business interest expense – not just the interest expense fairly attributable to the taxpayer's non-taxable interest and dividends – be reduced by the amount of those nontaxable interest and dividends.[2] After allowing a deduction for business interest expense against business interest income, the statute limits the interest expense deduction to "the amount, if any, by which the balance of interest expense exceeds interest and dividend income . . . not subject to allocation by formula." Cal. Rev. & Tax. Code § 24344(b). The reduction of the interest expense deduction by the amount of the nonbusiness interest and dividend income is absolute and unconditional. There is no "matching," no "correlation," no "economic relationship," no anything; just a dollar-

accepted methods, including direct tracing or apportionment based on income or asset values. *See, e.g.*, Treas. Reg. §§ 1.163-8T(a)(3) (providing for direct tracing), 1.265-1(c) (providing for direct tracing, or apportionment based on facts and circumstances), and 1.861-9T (providing for the apportionment of interest expense to taxable and non-taxable income-producing activities and assets by an asset method or gross income method). As explained below, however, such accepted methods of interest expense allocation are a far cry from what we have here.

[2] As we noted in our petition, (*see* Pet. 8 n.7), California permits a taxpayer to offset its business interest expense against its "interest income subject to allocation by formula," Cal. Rev. & Tax. Code § 24344(b), *i.e.*, apportionable or "business" interest income. Hence, it is the "net" business interest expense – the interest expense attributable to business income that remains after subtracting apportionable interest income – that is at issue here.

for-dollar reduction in the otherwise permitted deduction by the amount of the nontaxable, nonbusiness income.

Second, what is clear from the plain language of the statute also is explicitly set forth in the stipulation in this case. The parties stipulated that "[b]efore the 'interest offset' computation was made starting with line 3 of Schedule R-5, nonbusiness interest expense (line 2 of Schedule R-5) was deducted from total interest expense (line 1 of Schedule R-5)." Stip. ¶ 11, CT 58. The only interest expense available for the interest-offset computation was therefore business interest expense, and that is precisely what the stipulation says: "*Thus, the remaining interest expense reported on line 3 of Schedule R-5 was business interest expense subject to the 'interest offset' computation.*" *Id.* (emphasis supplied).[3]

Consequently, this case does not raise the question whether California may adopt a "rule for correlating, or matching, a corporation's interest expense with the category of income . . . to which it *relates*," (Br. Opp i) (restating Question Presented) (emphasis supplied), a question that both petitioner and respondent would answer in the affirmative.[4] Rather, it raises the question whether California may adopt a rule for allocating a corporation's interest expense to nontaxable income to which it does *not relate*. As the trial court found – and the Court of Appeal did not question this finding:

[3] The stipulated facts therefore put to rest any debate over the question whether the interest-offset provision applies to nonbusiness interest expense. It does not. Accordingly, there is no need in this case to consider respondent's astonishing disavowal of its own tax return instructions, based upon its theory that "nothing in the statutory provisions of section 24344(b) calls for the elimination of nonbusiness interest expense as part of the calculation of interest expense deduction." Br. Opp. 17 n.9.

[4] Respondent's citation of cases from this Court that stand for this proposition is therefore beside the point. Br. Opp. 13-14.

> here the parties have stipulated that no portion of the proceeds of the loans generating the interest expense deductions herein went to any nonunitary corporation, each of which was responsible for its own borrowings. (J.S. ¶ 9). Thus, it appears that no portion of the interest expense deduction can be attributable to the generation of the . . . exempt dividends.

Pet. App. 26a-27a.

Third, respondent's attempt to justify the interest-offset provision on the ground that "money . . . is fungible" (Br. Opp. 12) and that "interest costs cannot be readily traced to the specific classification of income which is generated from both business and nonbusiness activities" (*id.*) is a classic non sequitur. Even if money is fungible, it does not follow that California may adopt any provision – no matter how arbitrary – to allocate interest expense between taxable and nontaxable income. In fact, the interest-offset does not even rise to the level of an arbitrary allocation provision, because, rather than allocating interest expense between taxable and nontaxable income, it simply assigns net business interest expense to nontaxable income. Moreover, respondent's position that it is too difficult to allocate interest expense to a particular category of income (*id.*) is inconsistent with California statutes, regulations, and return requirements that provide for just such allocation. *See, e.g.*, Cal. Rev. & Tax. Code § 24425 (excluding from measure of tax "[a]ny amount otherwise allowable as a deduction which is allocable to . . . income not included in the measure of the tax"); Cal. Code Regs. tit. 18, §§ 24344(c)(3), (4) & (5) (making appropriate allocation); Cal. Code Regs. tit. 18, § 25120(d) (requiring deduction to be "fairly distribute[d]" among business and nonbusiness income).

Finally, respondent's assertion that the interest-offset provision serves to close a tax loophole is unfounded. Respondent asserts that this alleged loophole arises because petitioner is "shielding its nonbusiness investment income from state taxation." Br. Opp. 11. But no

such loophole exists on the facts of this case. Rather, as stipulated by the parties, all of that nonbusiness investment income was taxable by Illinois, petitioner's state of domicile. Stip. ¶ 8, CT 57.

III. RESPONDENT'S CONTENTION THAT THE INTEREST-OFFSET PROVISION DOES NOT DISCRIMINATE AGAINST INTERSTATE COMMERCE CANNOT WITHSTAND ANALYSIS

The interest-offset provision discriminates against interstate commerce for two, independent reasons. First, it provides more favorable interest expense deductions for domiciliary than for nondomiciliary corporations, contrary to *South Cent. Bell Tel. Co. v. Alabama*, 119 S. Ct. 1180 (1999), among other decisions. Second, it allows interest expense deductions based on the extent to which a corporation's subsidiaries conduct business in California, contrary to *Fulton Corp. v. Faulkner*, 516 U.S. 325 (1996), among other decisions. As set forth below, respondent's scattered responses to these claims lack merit.

1. Respondent's contention that the interest-offset provision is constitutionally tolerable because it does not apply "in all cases in which a multistate corporation receives dividends from nonunitary subsidiaries" (Br. Opp. 18) is beside the point. As the Court has observed, "[w]e need not know how unequal the Tax is before concluding that it unconstitutionally discriminates." *Maryland v. Louisiana*, 451 U.S. 725, 760 (1981). Furthermore, "[t]he volume of commerce affected measures only the *extent* of the discrimination; it is of no relevance to the determination whether a State has discriminated against interstate commerce." *Wyoming v. Oklahoma*, 502 U.S. 437, 455 (1992) (emphasis in original).

2. Respondent also contends that domiciliary and nondomiciliary corporations are not "similarly situated" (Br. Opp. 18) for Commerce Clause purposes and that the "constitutionally relevant basis for comparison lies not between domiciled and nondomiciled corporations but

rather between corporations that elect to borrow money while also earning nonbusiness interest and dividends not subject to California tax and corporations that borrow money without also earning such nonbusiness interest and dividends." Br. Opp. 18. The contention has no support in this Court's Commerce Clause jurisprudence.

It is true, of course, that "any notion of discrimination assumes a comparison of substantially similar entities." *General Motors Corp. v. Tracy*, 519 U.S. 278, 298 (1997). In determining whether entities are "substantially similar," this Court has considered whether the entities serve the same markets and whether removal of the supposed discriminatory burden would "serve the dormant Commerce Clause's fundamental objective of preserving a national market for competition undisturbed by preferential advantages conferred by a State upon its residents or resident competitors." *Id.* at 299. In this case, two corporations identical in every respect except for their state of domicile clearly are "substantially similar entities" for purposes of discrimination analysis under the Commerce Clause. *See, e.g., South Cent. Bell*, 119 S. Ct. 1180. Indeed, if respondent's gerrymandered definition of "substantially similar entities" could inform Commerce Clause analysis, it would invite the very type of "economic Balkanization" that the Commerce Clause was designed to prevent, *Hughes v. Oklahoma*, 441 U.S. 322, 325 (1979), by permitting states to favor in-state over out-of-state corporations under the guise of a constricted classification of "substantially similar entities."

3. There likewise is no substance to respondent's next assertion that "the substantive provisions of a tax do not have a discriminatory effect if the tax is fairly apportioned." Br. Opp. 21. This Court's cases make it clear that the fair apportionment and nondiscrimination criteria of its contemporary Commerce Clause analysis are separate and independent requirements. *See, e.g., Complete Auto Transit, Inc. v. Brady*, 430 U.S. 274, 279 (1977) (articulating four-prong Commerce Clause test including "fair apportionment" *and* "nondiscrimination" requirements). Thus,

in *Westinghouse Elec. Corp. v. Tully*, 466 U.S. 388, 399 (1984), the Court observed that "'[f]airly apportioned' and 'non-discriminatory' are not synonymous terms" in striking down a fairly apportioned New York income tax that was, nevertheless, unconstitutionally discriminatory. Indeed, the Court has flatly declared that "[e]ven if a tax is fairly apportioned, it may discriminate against interstate commerce." *Amerada Hess Corp. v. Director, Div. of Taxation*, 490 U.S. 66, 75 (1989).

4. In attempting to defend the feature of the interest-offset rule permitting an interest expense deduction corresponding to the extent that a corporation's subsidiaries conduct business in a state, respondent contends that it survives Commerce Clause scrutiny because it was "intended 'to avoid double taxation at the corporate level of income which has already been subjected to California taxation in the hands of the dividend-declaring corporation.'" Br. Opp. 22 n.12 (quoting *Pacific Tel. & Tel. Co. v. Franchise Tax Bd.*, 7 Cal. 3d 544, 548 (1972)).[5] This allegedly benign intent is insufficient to protect the statute's disparate treatment of corporations with in-state subsidiaries and corporations with out-of-state subsidiaries from attack under the Commerce Clause. It is well established that a determination that a state tax violates the Commerce Clause "may be made on the basis of either discriminatory purpose or discriminatory effect." *Bacchus Imports, Ltd. v. Dias*, 468 U.S. 263, 270 (1984) (citations omitted). The discriminatory effect of favoring investments in in-state over out-of-state corporations is incontrovertible. *See Fulton Corp.*, 516 U.S. 325.

[5] In advancing this argument, respondent implicitly acknowledges that the interest-offset provision, in fact, operates to impose a second tax upon the nonbusiness dividends not taxable by California, thereby creating the need for the exemption. This is in clear contradiction of its earlier statement that the interest-offset provision does not result in the taxation of such dividends. Br. Opp. 10-11.

Nor does respondent advance the analysis by suggesting that "[i]nasmuch as the dividend-producing income has already been taxed in California, no advantage is afforded to California subsidiaries over foreign subsidiaries" (Br. Opp. 22 n.12) by the allowance of the interest expense deduction with respect to income from in-state subsidiaries. The observation is irrelevant to the question before the Court. The question is not whether the interest-offset provision favors the dividend-*paying* corporation; the question is whether it favors the dividend-*receiving* corporation. Plainly it does, because only dividend-receiving corporations with in-state subsidiaries are entitled to the benefit of the interest expense deduction.

CONCLUSION

The petition for a writ of certiorari should be granted.

Respectfully submitted,

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